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# Is More Credit the Best Way to Assist Beginning Low-Equity Farmers?

**G**overnment programs to assist beginning farmers enjoy strong political support. Current Federal programs use credit enhancements to help beginning farmers purchase commercial farms; but higher debt loads increase financial risk. Future Federal policy may need to go beyond traditional credit programs and encourage equity investments or provide tax advantages to landowners who sell or rent their land to beginning farmers.

Current efforts at both the Federal and State level rely on credit enhancements to help beginning farmers purchase commercial farms; but higher debt loads increase financial risk. A fourth of the commercial farmers under 35 years of age have a net worth of less than \$100,000, while a viable commercial farming operation requires over \$500,000 in capital. Because they often cannot afford high-quality land and inputs, beginning low-equity farmers have significantly lower crop yields and productivity than established, well-capitalized farmers. Given the gap between resources on hand and the resources needed to effectively compete, future Federal policy may need to go beyond traditional credit programs to facilitate control of productive assets by beginning farmers rather than immediate ownership of those assets.

## Where Do Young Low-Equity Farmers Obtain Capital?

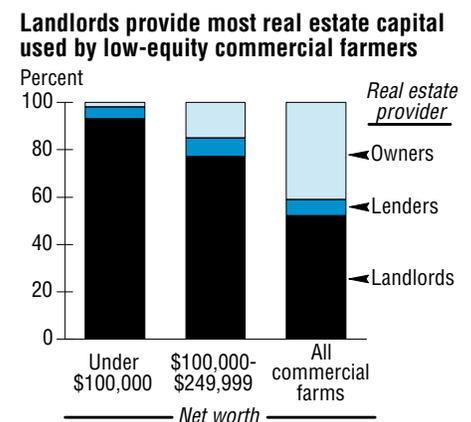
To obtain the capital needed to farm, young people may use their own equity capital, equity capital provided by others, or debt. Sources of owner equity include savings (which includes retained earnings once a farm is operating), intergenerational transfers, or off-farm income. Alternatively, equity capital can be obtained from external sources such as landlords (land leasing) or contractors (production contracts). Debt always requires contractual payments regardless of the income generated, whereas the payments made to providers of equity are generally tied to income. Thus, the use of equity generates less financial risk for a farm than debt. With debt financing

and owner equity, farmers have greater control since they both own and manage the farm's asset. When equity is provided by a nonfarm investor, the farmer may have to share both ownership and control of the farm.

**Land Leasing.** Over 20,000 young low-equity individuals currently operate a commercial farm. Most have obtained the land needed to farm by renting rather than purchasing. Only 15 percent of these low-equity farmers received most of their real estate capital from lenders. Landlords, in fact, supplied over 90 percent of the total real estate capital managed by low-equity farmers in the early 1990's (fig. 1).

**Debt.** In the early 1990's, lenders supplied only 2 percent of the capital low-equity farmers used to finance real estate. Lenders, however, provided these farmers with over a third of the nonreal estate capital they used to finance machinery, equipment, and variable inputs. Low-equity farmers'

Figure 1



Source: Compiled by Economic Research Service from Farm Costs and Returns Survey, 1991-94.

lack of reliance on debt, especially for financing real estate, reflects their financial vulnerability. About half of all young low-equity farmers fail conventional underwriting standards and have difficulty obtaining commercial credit. Low-equity farms that relied on debt were larger than farms that borrowed less; but there is no indication they were more profitable.

#### Trade Credit and Machinery Leasing.

Young low-equity operators obtain much of their non-real-estate capital from merchants or dealers using machinery leasing or trade credit. About 15 percent of all young low-equity crop farmers lease some machinery. Merchants and dealers also represent an important source of credit to low-equity crop farmers to whom they supply over 20 percent of non-real-estate credit needs.

**Intergenerational Transfers.** Inheritances, gifts, and preferential rental arrangements are a major source of capital to young low-equity farmers. A recent survey of Iowa farmland owners indicates about half of all Iowa farmland will either be willed or transferred to family members upon the owner's death. Only 10 percent of all land is expected to be sold to nonfamily members. To preserve the family-owned farm, policymakers have proposed further reducing taxes on the transfer of farm assets to family members. This would benefit young farmers who expect to inherit substantial wealth, but it could also result in more farm wealth being held by fewer farms.

**Production Contracts.** Young low-equity farmers can use production contracts to increase their operating capital. Through contracting arrangements, contractors (processors) provide much of the operating capital, thus reducing the farmer's investment. For example, in the early 1990's commercial-sized livestock farms with production contracts reported an average net worth of \$385,000 compared with \$667,000 for all other livestock farms. Contractors also assume

#### About the Data

This study uses data from USDA's Farm Costs and Returns Survey (FCRS). The FCRS is a multiframe, stratified survey of farms and ranches conducted annually by USDA. Most of the estimates discussed represent averages over the 1991-94 period.

*Commercial farms* were defined as having over \$50,000 in annual sales. These 550,000 farms accounted for over 90 percent of the value of all farm production. *Low-equity farms* were defined as commercial farms with less than \$100,000 of net worth.

USDA defines a *qualified beginning farmer* as one who has not operated a farm or ranch for more than 10 years and substantially participates in the operation of the farm or ranch.

much of the farmer's price and production risk, reducing the variability of cash-flows and increasing farmers' debt capacity. The combination of reduced investment and less price and production risk can make contract production an attractive option for young low-equity farmers.

**Off-Farm Work.** An off-farm job can enable a young farmer to start small and use off-farm income to build equity. Most commercial-sized operations are labor intensive, however, leaving little time for an off-farm job. Furthermore, off-farm employment opportunities are limited in many remote rural locales. Future technology may increase off-farm employment opportunities both by reducing onfarm labor requirements and by creating jobs (via telecommunications) with distant employers.

#### USDA Assistance Focuses on Credit

USDA assists young or beginning farmers primarily through credit programs administered by the Farm Service Agency (FSA). FSA administers both direct and guaranteed lending programs for family farmers. Many of the loan funds for these programs

are targeted for "qualified beginning farmers" (see box). Through FSA's guaranteed loan program, qualified beginning farmers obtain credit from a lender who makes and services the loan while FSA guarantees the lender against losses on up to 90 percent of the principal and accrued interest. For young low-equity farmers who are unable to qualify for a guaranteed loan from a commercial lender, the FSA makes a limited number of direct farm ownership and operating loans.

Since 1992, FSA has offered downpayment loans to qualified beginning farmers to assist in the purchase of land. Under this program, FSA can finance up to 30 percent of the farm purchase price at a subsidized interest rate if the borrower puts down 10 percent. The FSA downpayment can be amortized over 10 years. Another lender supplies the remaining financing, which can be guaranteed by FSA, if the lender is eligible. The Federal Agriculture Improvement and Reform Act of 1996 (1996 Act) increased the guarantee to 95 percent for the downpayment program. Nonetheless, some young, low-equity farmers are likely to find it difficult to come up with the 10-percent downpayment. Also, a 10-year amortization on FSA's portion can put strains on cash-flow during the crucial start-up period.

Young low-equity farmers desiring to purchase land may also use the 1996 Act's joint financing option under the farm ownership program. Using this option, FSA can make a real estate loan to a farmer for up to half of the purchase price at an interest rate of 4 percent. Another lender will provide the remainder of the financing, which can be guaranteed up to 90 percent by FSA. Because of a longer amortization, loan payments would be lower than for the downpayment loan program. Also, the farmer does not have to come up with the 10-percent downpayment. However, since a large share of the farm ownership loan funds must be held for the downpayment loan program, loan funds are limited for other FSA programs.

Both the guaranteed and direct lending programs appear to have been successful at delivering credit to young low-equity farmers. Among low-equity operators under 40 years of age, FSA supplied over a third of real estate credit through direct loans. Low-equity farmers also participate in FSA-guaranteed programs. These programs may have helped commercial banks make 60 percent of the non-real-estate debt owed by low-equity farmers (fig. 2). Access to credit, however, does not ensure financial success. Delinquency rates for FSA's direct farm loans exceeded 20 percent during the early 1990's compared with less than 2 percent for commercial banks, suggesting that many who received FSA direct loans may have lacked the means of achieving long-term financial success.

Three provisions in the 1996 Act may improve beginning farmers' use of FSA credit programs to achieve success. First, eligibility for the direct and guaranteed operating loan programs and the direct farm ownership program is now limited to a specific number of years. Second, to receive additional FSA funds, farm businesses must not be delinquent nor, with certain exceptions, can they have had debts forgiven by FSA. Finally, more of FSA's loan funds will be targeted toward qualified beginning farmers. These provisions should channel FSA funds toward beginning farms who are most likely to succeed.

## Assistance from States and the Farm Credit System

State governments often operate beginning farmer assistance programs using "aggie bonds." Aggie bonds are tax-exempt bonds issued by States with proceeds used to back private farm loans or contract sales. Because the interest payments to the bondholders are exempt from Federal income taxes, interest rates charged to the borrower can be lower than commercial bank rates. As many as 30 States have such programs, but few beginning farmers have been assisted because of the limited size of these programs.

Under current law, Farm Credit System (FCS) associations are required to prepare a program for "furnishing sound and constructive credit and related services to young, beginning, and small farmers." However, USDA data indicate that FCS associations lend primarily to older and more established operators. The Farm Credit Administration reported that in 1994 only 4 percent of FCS debt was owed by farmers under 36, well below the 14-percent share of farm debt owed by such farmers.

## Policy Alternatives

Guaranteed and direct farm-ownership loan programs, while extremely helpful, are likely to have limited success at assisting young low-equity

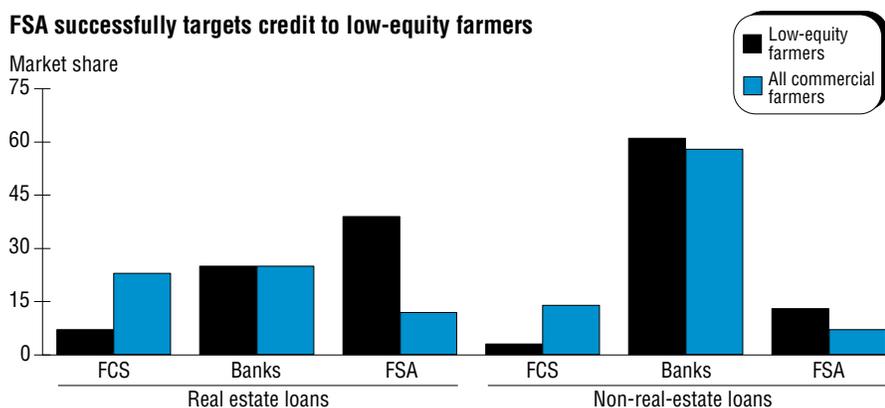
farmers, most of whom cannot afford to borrow enough to acquire commercially viable farms. Doing so would make their business financially unstable and vulnerable to failure.

While we do not recommend adoption of any approach without further study, policy options which facilitate beginning farmers' leasing arrangements or access to equity capital deserve attention.

Given their heavy reliance on leasing, young low-equity farmers could benefit from policies which either provide lease financing or which make it advantageous to lease to beginning farmers. Most beginning farmer credit programs are geared toward purchasing real estate. While such assistance is useful, beginning farmers may benefit more from production credit, which can be used to lease land and equipment. Government credit programs should be flexible enough to meet beginning farmers' needs.

Beginning farmers could also benefit from a more competitive market for their loans. Congress could consider requiring the FCS to increase lending to young low-equity farmers. While current law encourages the FCS to do so, no specific target exists for lending to this group. New legislation could establish such goals, similar to requirements placed on Freddie Mac and Fannie Mae to serve low-income borrowers and underserved regions.

Figure 2



Note: Low-equity farmers are commercial farmers who have a net worth of less than \$100,000.  
Source: Compiled by Economic Research Service from Farm Costs and Returns Survey, 1991-93.

Finally, tax initiatives that focus on the landlord-tenant relationship could be examined. For example, tax reductions on the capital gains earned on land sold to beginning farmers or to entities which lease land exclusively to beginning farmers could be considered. State and local governments could consider lowering property taxes on land operated by qualified beginning farmers. Such initiatives could provide beginning farmers with more affordable access to the assets they need for productive, high yield operations.

In addition to leasing, infusions of equity capital can provide young low-equity farmers with the financing they need without incurring additional debt. To attract equity capital, a young low-equity farmer would need to organize the farm business in such a way that investors could easily purchase an ownership interest in the farm and limit their liability to the amount of their investment. This could be accomplished by forming a limited partnership or a subchapter S or limited liability corporation. Subchapter S and limited liability corporations are business forms that combine the tax attributes of a partnership with the limited liability of a corporation.

These organizations are created under State law. States could consider legislation to make the formation of these business entities easier for farms. For example, family farm businesses could be exempted from filing charges or some reporting requirements. Where appropriate, State statutes could be changed to allow these types of business organizations to own farming assets.

Programs could also be considered that stimulate the accumulation of wealth. For example, special "aggie savings accounts" may be considered where young farmers and others could make tax-exempt or tax-deferred contributions. Proceeds would subsequently be used to finance land purchases or investment in other farming assets used exclusively by beginning farmers. Such a program could encourage the creation of privately owned venture capital funds serving beginning farmers' equity capital needs.

Initiatives that encourage equity investments, such as the tax policies mentioned above, have certain advantages over traditional credit programs. The administrative costs of a program based on tax incentives may be lower. Such programs do not encourage young low-equity farmers to take on additional financial risk, much of which is now shifted to the Federal Government. Privately financed equity investments do not increase the Federal Government's financial risk. A disadvantage of a tax incentive is that it costs the Treasury in lost tax revenues. Also, credit programs may be easier to target than tax incentives. The tax code generally provides incentives to all eligible activities, not just to those approved by USDA or some other agency.

### Conclusions

Traditional credit programs have limited potential to assist young low-equity farmers. The capital requirements of modern commercial farming operations make it difficult to rely primarily on debt financing without taking on excessive financial risk. Thus, most young low-equity farmers rely on leasing to obtain the capital required to farm.

Provisions in the 1996 Act shift more FSA credit assistance to beginning farmers. Much of this assistance will be implemented through guaranteed loans. If the goal of Federal policy is to increase the number of new entrants into farming, future programs could go beyond traditional credit enhancements and consider the importance of nondebt capital provided by landlords or investors.

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### Further Readings

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